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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 96-0602/96-0607 FIT
Financial Institutions Tax
For The Periods: 1992-1993

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Financial Institutions Tax - Subpart F Income – Foreign Corporation

Authority: IC 6-5.5-1-2; IC 6-3-1-27; 26 U.S.C.A. § 862

The taxpayer asserts that its subsidiary is a controlled foreign corporation and the income derived from it is Subpart F income not includible in the combined income tax base.

II. Financial Institutions Tax - Foreign Source Income – Overseas Military Banking Facilities

Authority: IC 6-5.5-1-2; IC 6-3-1-27; 26 U.S.C.A. § 7701; Treas.Reg. 1.862-1

The taxpayer asserts that its overseas military banking facilities should be treated as foreign source income.

III. Financial Institutions Tax – Audit Adjustments

Authority: None

The taxpayer requests the Department to make several computation adjustments.

IV. Financial Institutions Tax - Denominator of Receipts Factor

Authority: IC 6-3-2-2; 45 IAC 17-3-10

The taxpayer does not agree with the auditor's calculation of the denominator of the receipts apportionment factor.

V. Financial Institutions Tax - Enterprise Zone Loan Interest Credit

Authority: IC 6-3.1-7

The taxpayer requests that certain adjustments be made regarding its enterprise zone loan interest credit.

STATEMENT OF FACTS

The taxpayer was a bank holding company incorporated in Indiana and was merged into an out of state domiciled bank holding company.

I. **Financial Institutions Tax** Subpart F Income – Foreign Corporation

DISCUSSION

The holding company was incorporated in the State of Delaware in 1991 as a wholly owned subsidiary of the taxpayer. The Controlled Foreign Corporation (Hereinafter "FC") was incorporated in Bermuda in January 1992 as a wholly owned subsidiary of the holding company. The day to day operations of the FC were located and managed solely in Bermuda and never had any physical or economic presence outside of Bermuda.

On its federal tax returns for years 1992-1993, the holding company income related to FC was classified on Form 1120 as "Other Income" rather than as Subpart F income. The taxpayer contends that in spite of this, the income derived from FC is Subpart F income. The taxpayer states that the FC qualifies as a controlled foreign corporation under IRC § 957 (IRC § 957 is defined below).

Subpart F income is defined in the Internal Revenue Code as income derived from sources outside the United States. IC 6-5.5-1-2 (2)(B) directs the taxpayer to subtract the following (among other items) in figuring adjusted gross income in financial institutions, "Income that is derived from sources outside the United States, as defined by the Internal Revenue Code." IRC § 957 defines a controlled foreign corporation as:

> [A]ny foreign corporation if more than 50 percent of –
>
> (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or
>
> (2) the total value of the stock of such corporations, is owned (within the meaning of section 958 (a)), or is considered as owned by applying the rules of ownership of section 958 (b), by the United States shareholders on any day during the taxable year of such corporation.

IRC Section 958 provides that "stock owned" means, among other things, "stock owned directly." That taxpayer asserts that because the holding company directly owns 100% of the stock of the "FC", the FC is a controlled foreign corporation.

The taxpayer notes that the calculation of Indiana adjusted gross income for purposes of the Financial Institutions Tax begins with taxable income as defined in Section 63 of the Internal Revenue Code. The holding company's federal taxable income included the FC's undistributed earnings pursuant to the federal Subpart F provisions. The taxpayer believes that holding company's income should be excluded from the Indiana tax base under the following positions:

(1) Subpart F income constitutes income "derived from sources outside of the United States" and should be deducted pursuant to IC 6-5.5-1-2,

(2) Subpart F income constitutes income from " transactions between parties that are included in the unitary group" and should be eliminated pursuant to IC 6-2.5-5-2

(3) Inclusion of MNB holdings subpart F income in the combined tax base facially discriminates against foreign commerce in violation of the Foreign Commerce Clause.

The taxpayer argues the Subpart F income should not be subject to Indiana tax because the income constitutes income "derived from sources outside the United States." IC 6-5.5-1-2 provides a deduction "income derived from sources outside the United States, as defined by the Internal Revenue Code." The Internal Revenue Service has recognized that the income in question was foreign source income and not other income as originally reported on the 1992 and 1993 tax returns. (See attached letter from IRS International examiner, dated June 8, 1998). The taxpayer committed an error in reporting the income as "other income" on its Form 1120, but given that it was foreign source income and the Internal Revenue Service recognizes it as such, to hold the taxpayer to its original error would result in the elevation of form over substance. It is also noted that the taxpayer received no advantage on the federal level by erroneously reporting the income this way to the Internal Revenue Service.

Given that the Department accepts the taxpayer's argument on the first issue, there is no need to address the taxpayer's alternative arguments. However, the amount included in "adjusted gross income" is the amount net of expenses. The expenses related to the dividends have been deducted on federal form 1120. Therefore, if Indiana starts with federal taxable income but allows a deduction of gross dividends, then the taxpayer, in effect, is receiving a double deduction of the expenses involved. Therefore, the taxpayer's expenses related to the dividends must be calculated and added back.

FINDING

The taxpayer's protest is partially sustained. The taxpayer's income is recognized as Subpart F income and is properly deductible in the calculating the Financial Institutions Tax. However, to prevent a double deduction, the taxpayer's expenses related to the dividends must be calculated and added back.

II. **Financial Institutions Tax** – Foreign Source Income – Overseas Military Banking Facilities

DISCUSSION

The taxpayer entered into a contract with the U.S. Department of Defense to operate Military Banking Operations (hereinafter "MBO's") at military bases in several foreign countries throughout the world. Under the terms of the contract, the taxpayer was compensated for the services that were performed in foreign countries. Again, the taxpayer did not specifically identify the income as foreign source income on its federal tax return. The Internal Revenue Service again recognized in a letter that this income was indeed foreign source income. (See attached letter from IRS International Examiner, dated June 8, 1998). This recognition had no affect on its federal income taxes.

The auditor contended that the income earned by the taxpayer's Indiana subsidiary, through the banking services provided by MBO's is U.S., rather than foreign source income, and is includible in the combined income tax base. The auditor suggests that the income is U.S. source because the source of the receipts is U.S. Government public funds paid to the Indiana subsidiary. The taxpayer contends that the income is foreign source income because the banking services were provided exclusively at foreign U.S. military bases.

IC 6-5.5-1-2 provides a deduction for "income derived from sources outside the United States, as defined by the Internal Revenue Code." The income earned from management of the MBO is considered "income from sources without the United States" under IRC § 862 (a)(3) which provides in pertinent part:

> The following items of gross income shall be treated as income from sources without the United States:
>
> (3) compensation for labor or personal services performed without the United States.

IRC Regulation Section 1.862-1(a)(1)(iii) lends additional support to this conclusion and provides that services performed outside of the U.S. shall be treated as income from sources outside the U.S.

Indiana's Adjusted Gross Income statute at IC 6-3-1-27 states , "United States", when used in a geographical sense, means the United States as defined in Section 7701 of the Internal Revenue Code. Section 7701(a)(9) of the Internal Revenue Code states, "The term "United States" when used in a geographical sense includes only the States and the District of Columbia."

The Indiana Adjusted Gross Income Tax statute defers to the Internal Revenue Code in the determination of the definition of United States. A review of the Internal Revenue Code and treasury regulations reveals that this income received from services performed outside of the United States is foreign source income. However, as in Issue I, the amount included in "adjusted gross income" is the amount net of expenses. The expenses related to the dividends have been deducted on federal form 1120. Therefore, if Indiana starts with federal taxable income but allows a deduction of the foreign source income, then the taxpayer, in effect, is receiving a double deduction of the expenses involved. Therefore, the taxpayer's expenses related to the dividends must be calculated and added back.

FINDING

The taxpayer's protest is sustained. The taxpayer's income is recognized as foreign source income and is properly deductible in the calculating the Financial Institutions Tax. However, to prevent a double deduction, the taxpayer's expenses related to the foreign source income must be calculated and added back.

III. Financial Institutions Tax – Audit Adjustments

DISCUSSION

A. Exempt Interest Income 1993

The taxpayer disagrees with the $506,608 and $592,895 federal tax-exempt interest income addback adjustments for two separate banks listed on page 29 of the Proposed Assessment. The amounts at issue include $360 and $405, respectively, of non-taxable Federal Reserve Bank stock dividends. The taxpayer requests that the Department review this issue and subtract the two amounts at issue from the addback.

B. Bad Debt Reserve Deductions (1992 and 1993)

The taxpayer had several bad debt reserve amounts subtracted from federal taxable income in computing adjusted gross income were properly deducted because they were included in federal taxable income as an accounting method change required by IRC Section 585(c)(3)(A). In arriving at adjusted gross income, IC 6-5.5-1-2(a)(4) specifically permits a subtraction from federal taxable income for

> [A]n amount equal to any bad debt reserves that are included in federal income because of the accounting method change required by Section 585(c)(3)(A) of the Internal Revenue Code.

The taxpayer made several deductions on their 1992 and 1993 Indiana Financial Institutions Tax

Returns to represent the capture of bad debt reserves required to be included in federal taxable income because of the accounting method change. These are listed on pages 8 and 9 on the taxpayer's protest.

C. Numerator of Receipts Factor (1992 and 1993)

The receipts of certain National City subsidiaries should be excluded from the numerator of the Indiana receipts factor. In calculating the numerator of the receipts factor for purposes of the Financial Institutions Tax, IC 6-5.5-2-4 provides that the numerator should include the following amounts:

> [A]ll the receipts of the resident taxpayer members of the unitary group from whatever source derived plus the receipts of the nonresident taxpayer members of the unitary group that are attributable to transacting business in Indiana.

The taxpayer lists several non-Indiana subsidiaries of the taxpayer that are not "transacting business in Indiana", as outlined in IC 6-5.5-3-1. The taxpayer requests that these receipts be excluded from the numerator of the Indiana receipts factor. These subsidiaries are listed on pages 9 and 10 of the taxpayer's protest letter.

FINDING

These issues are subject to verification and review by the Audit Division.

IV. **Financial Institutions Tax - Denominator of Receipts Factor**

DISCUSSION

The taxpayer does not agree with the auditor's calculation of the denominator of the receipts apportionment factor. In accordance with 45 IAC 17-3-10, "receipts" includes:

> [A]ll gross income as defined in Section 61 of the Internal Revenue Code. However, upon the disposition of assets such as securities and money market transactions, when derived from transactions and activities in the regular course of the taxpayer's trade or business, receipts are limited to the gain (as defined in Section 1001 of the Internal Revenue Code) that is recognized upon the disposition.

The administrative code does not specifically instruct that mortgages disposed of in the ordinary course of business should be limited to the gain recognized upon the disposition. In absence of statutory direction the Department looks to the analogous Adjusted Gross Income Tax statute at IC 6-3-2-2(m), which provides the following:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to *fairly reflect* and report the income derived from sources within the state of Indiana by various taxpayers. (emphasis added)

The Department concludes that in the audit calculation of the denominator of the receipts apportionment factor, the gain recognized upon the disposition of the mortgages fairly reflects the income derived from sources within the State of Indiana.

FINDING

The taxpayer's protest is denied.

V. **Financial Institutions Tax** – Enterprise Zone Loan Interest Credit

DISCUSSION

The taxpayer asserts that in accordance with IC 6-3.1-7, it is entitled to a credit against its Indiana tax liability equal to 5% of interest income received from a loan made to an entity that uses the proceeds for: (1) a purpose directly related to a business located in an enterprise zone, as defined in IC 4-4-6.1; (2) an improvement that increases the assessed value of real property located in the enterprise zone; or (3) rehabilitation, repair, or improvement of a residence.

In the original returns, the taxpayer only claimed the credit for consumer loans, but prior to the start of the audit in 1995 the taxpayer initiated a project to identify the qualifying commercial loans eligible for the credit. The taxpayer filed new LIC schedule Loan Interest Credit forms for the years 1992 and 1993. These LIC schedules would normally need to be filed with amended returns and would be treated as a claim for refund, however, since the taxpayer has a current audit with liabilities with the Department, the Department will request that the audit division review these loan credit liabilities to see if they are valid, and if they do qualify, the Department will offset the amounts against the existing audit liabilities.

FINDING

The taxpayer's protest is sustained subject to audit review for verification.